Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:1:TL-N-1580-01
JEKagy

date:

to: Will Jackson, Group 1362
Attn: Rick Ollendick

from: RICHARD E. TROGOLO
Associate Area Counsel
(Large and Mid-Size Business)

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subject: **NOL Utilization by** [redacted]

This memorandum responds to your request for assistance dated [redacted], concerning [redacted], a subsidiary of [redacted]. Your memorandum raised two issues for our consideration. Initially, having supplied us with two Closing Agreements executed by Appeals in [redacted] regarding an earlier cycle, you queried whether the language in the Closing Agreements precluded the Service from challenging the taxpayer's use of a net operating carryforward. As a second matter, to the extent we believe that the language of the Closing Agreements does not preclude the Service from challenging the taxpayer's use of the net operating loss carryforward, you asked us to comment on the applicability of a "principal purpose standard" to the taxpayer's articulated business purpose for arranging its loss subgroups.

Each of the issues raised by your memorandum will be addressed separately. This memorandum addresses only the initial issue. As with other legal memoranda issued to any IRS office or employee, this memorandum should not be cited as precedent.

ISSUE:

Whether the two [redacted] Closing Agreements, either individually or in conjunction, serve to preclude the Service from challenging the use of the taxpayer's net operating loss carryforward.

CONCLUSION:

We do not believe that the two Closing Agreements, either individually or in conjunction, prohibit the Service from challenging the use of the taxpayer's net operating loss carryforward in this instance.

FACTS:

In [redacted], the [redacted] was forced to file for reorganization under the bankruptcy laws. In [redacted], after divesting itself of its [redacted] assets, it emerged from bankruptcy as the [redacted] with various real estate and energy-related operations. During [redacted] and in years following bankruptcy, [redacted] was the common parent of an affiliated group of corporations which filed consolidated federal income tax returns.

The [redacted] group's consolidated return for the [redacted] taxable year was examined by the Service and adjustments were proposed regarding the determination of the taxpayer's [redacted] consolidated net operating loss. One of the adjustments related to a loss carryover from the consolidated return filed by the group for the [redacted] tax year. Eventually, all issues raised in the examination of the [redacted] tax year were settled by Appeals and a three page Closing Agreement was executed for the [redacted] tax year (the "[redacted] Closing Agreement"). A separate two page Closing Agreement was also executed to dispose of the issue which related to the [redacted] tax year (the "[redacted] Closing Agreement").

Generally speaking, by executing the [redacted] Closing Agreement, the parties agreed to the recognition in prior years of over $[redacted] in interest income, and the simultaneous application of the prior years' net operating losses of over $[redacted], prior to the utilization of any [redacted] operating losses. In addition, the [redacted] Closing Agreement was made contingent upon the timely execution of the [redacted] Closing Agreement.

In the [redacted] Closing Agreement, the parties agreed upon amounts representing the taxpayer's [redacted] consolidated net operating loss ($[redacted]), [redacted] investment tax credit ($[redacted]), [redacted] energy investment tax credit ($[redacted]), and the amount of aggregate consolidated net operating loss carryover from tax years prior to [redacted] ($[redacted]). See, paragraphs (3) and (4) of the [redacted] Closing Agreement. Moreover, the Closing Agreement included the following language:

> The Commissioner shall not challenge, for carryback or carryover purposes, either the amount of the net

> operating loss incurred by the Affiliated Group for taxable year [redacted] or the status thereof as a consolidated net operating loss of the Affiliated Group.

See [redacted] Closing Agreement, at ¶ (3).

In addition, paragraph (5) of the [redacted] Closing Agreement also noted that the amount of the net operating loss carryover from years prior to [redacted] ($[redacted]) was "subject to any timely adjustments required by law." Paragraph (7) of the [redacted] Closing Agreement made the agreement contingent upon the timely execution of the [redacted] Closing Agreement.

From a historic perspective, in the early to mid-[redacted]s, [redacted] became a diversified company with interests in [redacted] businesses. Nevertheless, as of [redacted], the [redacted] group's NOL was still in excess of $[redacted]. By [redacted], [redacted] ("[redacted]") had purchased a controlling interest ([redacted]%) in [redacted]. Following the acquisition, the [redacted] group continued to file separate consolidated returns.

During the late [redacted]s, [redacted] began to divest itself of its [redacted] businesses and later most of its [redacted] businesses. During those years, [redacted] also began to change its business structure. For instance, in [redacted], [redacted] completed the acquisition of all of the common stock of [redacted] ([redacted]). [redacted] was engaged in the sale of [redacted] in the State of California. Before the acquisition closed, [redacted] already owned [redacted]% of [redacted], and [redacted], which owned [redacted]% of [redacted], owned an additional [redacted]% of [redacted]. Moreover, [redacted]'s principal shareholder was chairman of the board and chief executive officer of both [redacted] and [redacted].

In [redacted], [redacted] also acquired three [redacted] companies (the [redacted]) from [redacted]. The [redacted] consisted principally of [redacted], and the [redacted] business [redacted]. These companies [redacted].

In [redacted], [redacted] arranged for the sale of the remaining [redacted] subsidiaries of the [redacted] group, based upon its belief that "[redacted] can realize more long term value for its shareholders by narrowing the focus of its operations."

That divestiture "virtually complete[d] the repositioning of the Company in the [redacted] sector."

Parenthetically, the consolidated income tax returns for the [redacted] through [redacted] tax years of [redacted] were not audited by the Service.

In [redacted], the [redacted] name was changed to [redacted] ("[redacted]"). In [redacted], in a reverse triangular merger, [redacted] acquired [redacted]. To effectuate the acquisition, [redacted] formed [redacted] in [redacted] as the acquisition company. In mergers which were completed on [redacted], [redacted] issued [redacted] shares of common stock in return for all outstanding common stock of [redacted] and [redacted]. In [redacted], [redacted] changed its name to [redacted] ([redacted]).

For financial accounting purposes, because the former shareholders of [redacted] owned more than [redacted]% of [redacted] following the mergers, the mergers were accounted for as a reverse acquisition, where [redacted] was deemed to have acquired [redacted] ([redacted]). Following the mergers, [redacted] and [redacted] filed consolidated income tax returns which included all [redacted]% or more owned U.S. subsidiaries. However, because of certain rights aggregating [redacted]% which were extended to holders of [redacted] Series [redacted] and [redacted] Stock in connection with the mergers, [redacted] continued to file a separate consolidated return. [redacted] was included on the [redacted]'s consolidated return.

The Service is currently examining the [redacted]-[redacted] taxable years of [redacted]. One of the issues being considered by the audit team is the utilization of the [redacted] net operating loss carryforward against the profits generated by the acquired [redacted]. In its early, informal responses to the Service's IDRs, the taxpayer has resisted supplying information about the potential NOL issue. The taxpayer's resistence appears based upon the taxpayer's belief that the [redacted] and [redacted] Closing Agreements preclude the Service from questioning any aspect of the NOL carryforward.

ANALYSIS:

Internal Revenue Code Section 7121(b) "Closing Agreements" provides:

> FINALITY.--If such agreement is approved by the Secretary . . . such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact--

(1) the case shall not be reopened as to the matters agreed upon or the agreement modified by any officer, employer, or agent of the United States, and

(2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside or disregarded.

Courts have unanimously held that closing agreements are meant to determine finally and conclusively a taxpayer's liability for a particular tax year. Hopkins v. United States, 146 F.3d 729, 732-33 (9th Cir. 1998). Yet, closing agreements are subject to ordinary principles of contract law and generally are interpreted under ordinary contract principles. See Rink v. Commissioner, 100 T.C. 319 (1993). Courts enforce the plain meaning of the agreement as drawn from its entirety. Silverman v. Commissioner, 105 T.C. 157, 166 (1995). Thus, if the essential terms of an agreement are deemed unambiguous, a court will not look beyond the four corners of the document to determine the parties' intent. See, e.g., Smith v. United States, 850 F.2d 242, 245 (5th Cir. 1988); P.J. Maffei Bldg. Wrecking Corp. v. United States, 732 F.2d 913, 916 (Fed. Cir. 1984).[1]

We conclude, and we believe that any court undertaking a similar, independent reading of the closing agreements would find, that the closing agreements are clear and unambiguous. We believe that the plain meaning of the closing agreements, when read in their entirety, clearly reflects both the parties' agreement as to the amount and legitimacy of the losses incurred by the taxpayer and the parties' intent to preclude the Service from again questioning, at some later date, either the amount of those losses or the status of the losses so determined.[2]

In considering whether to raise the instant issue, the Service is not seeking to disturb the parties' agreement regarding the amount or status of the losses as determined by the closing agreements. If the Service decides to raised the potential adjustment, the Service will be questioning whether

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[1] Were a court to find a closing agreement ambiguous, the court would review any extrinsic evidence offered by the parties to determine the intent of the parties.

[2] However, it is also clear that the amount of the loss carryforward from years prior to [redacted] was specifically subject to future "timely adjustments required by law."

losses, incurred by [redacted] or [redacted], may be absorbed by the profits generated by the later acquired [redacted]. The issue will turn on the nuances of the consolidated return regulations and will focus on the question of whether the NOL of what used to be [redacted] can be offset against profits of insurance entities recently acquired by [redacted] from a subsidiary of [redacted] one of [redacted]'s controlling shareholders. The amount or substance of the NOL carryforward will not be at issue.

Based upon the foregoing, but without having yet opined on the strength of the consolidated return issue which you wish to consider, it is our opinion that you are not precluded by the [redacted] and [redacted] Closing Agreements from raising the consolidated return issue. In the future, if we favorably opine on the legitimacy of the potential consolidated return issue and the taxpayer fails to produce the factual information necessary to the determination of whether the [redacted] consolidated net operating loss may be offset against the income of the recently acquired [redacted], then we will assist you in the preparation, issuance and enforcement of summonses to obtain the necessary information.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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By: _____
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